

Meeting the Challenge of a Dynamic Market:

Hedge Fund Services

step up



As the hedge fund market continues its upward climb, many have raised questions about how to best support this asset class in the future. With increasing regulatory scrutiny, coupled with increasingly risk-laden investment strategies, the quality of service of third-party providers takes on new significance and greater importance. Here's why...

The hedge fund market continues to grow, forming more distinct segments as it matures and responds to the entry of institutional investors. Furthermore, the original model of bold startups launched by one or two savvy traders pursuing a creative investment strategy has given way to the entrance of many large global asset managers who are entering the space in an effort to grow and diversify their businesses. The "fund of hedge funds" model that offers investors the opportunity to invest in several hedge fund strategies at once has become increasingly popular. These funds of funds offer the potential for absolute returns with the additional benefits of diversification, professional screening and oversight.

When it comes to service, each segment has distinct demands. Smaller single-strategy funds expect a high-touch, one-to-one approach, while larger players look for more industrial strength. Funds of funds have a completely separate set of needs. "Larger hedge fund complexes may come

to dominate," says Bhagesh Malde, global business head for Hedge Fund Services at JPMorgan, "but the smaller players will always be important as the industry's essential source of creativity and innovation. Our goal is to serve all segments well."



Bhagesh Malde

In response to this dynamic market, global banks seeking to scale operations and set new standards for value-added services have acquired many of the boutique hedge fund administrators once common in the field. At the same time, the relationship between a hedge fund and its administrator has become increasingly important as institutional investors enter the market and as declining returns compel managers to find cost-effective solutions. Occasional scandals have also highlighted the risk of loose controls, causing legislators and

regulators to frequently debate the need for more stringent hedge fund oversight. The Securities and Exchange Commission (SEC) rule requiring hedge fund managers with 15 or more U.S. clients and more than \$25 million in assets to register and comply with reporting requirements and periodic audits took effect in February 2006 for U.S. managers who have customer lock-ups of less than two years. Similarly, pressure for increased regulation began mounting last year in the United Kingdom when the Financial Services Authority (FSA) published two discussion papers about the risks for institutional and retail consumers in the hedge fund industry.

Growth Outlook Remains Strong

Hedge fund net inflows dipped in 2005 as returns for the most part declined, but few observers expect hedge fund growth to slow any time soon. Annual growth forecasts range from 15–20% for the next three to five years, with hedge fund assets projected to double from \$1 trillion currently to \$2 trillion by 2008 or 2009. At that point, according to a report from TowerGroup, hedge fund services will be a \$2.5 trillion industry.

Hedge funds continue to attract assets from their original base of high-net-worth individuals, but much of their incremental growth is expected to come from institutional investors shifting allocations from other asset classes into hedge funds and alternative investments with the goal of improving returns and diversifying risk. “Hedge funds are capturing a bigger share of global investable capital,” says Stephen Castree, head of strategy and product development for JPMorgan Hedge Fund Services, “but in percentage terms they are still a small fraction of the whole, relative to traditional equity and fixed income asset classes.” In short, hedge funds have plenty of room to grow.

A global perspective points to some key differences in regional hedge fund growth patterns. In the United States, where hedge funds have long been popular, growth is slowing, although new players and strategies continue to emerge. The pace of growth is currently faster in Europe, where the business is roughly 10 years younger than it is in the United States. The next big growth market could be Asia, where hedge funds are just starting to become popular.

New Challenges for Managers...

Declining hedge fund returns — whether cyclical or by sector — combined with new demands from institutional investors, are compelling managers to re-evaluate investment and operational strategies. In the process, they are creating new opportunities and challenges for their service providers.

By nature, hedge funds profit by identifying and exploiting market inefficiencies; but as the number of managers pursuing a given strategy increases, the inefficiencies become scarcer and the manager has to move away from the pack to deliver the alpha. As a result, hedge fund portfolios comprise ever more complex investments as strategies become more diverse and specialized.

According to a 2003 study by Capco, operational issues account for more than 50% of hedge fund failures.¹ With returns hard to find, hedge fund managers are facing a trade-off between the need to stay focused on their core competencies and the need to invest in the physical and human capital required to maintain appropriate controls, pointing to a growing market for high-quality third-party administration services. The quality of hedge fund administration is also critically important to institutional investors

1 Source: “Understanding and Mitigating Operational Risk in Hedge Fund Investments: A Capco White Paper,” March 2003

whose fiduciary obligations require them to perform more stringent due diligence than a high-net-worth individual investor might require of a hedge fund. In this sense, the use of a qualified and reputable hedge fund administrator is a marketing tool as well as a practical necessity for most hedge fund managers.

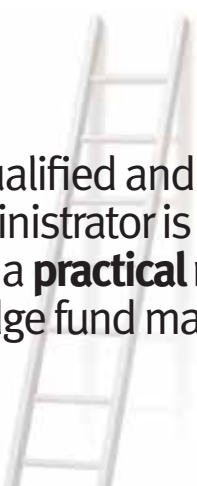
“Most European hedge funds were formed after well-publicized losses in a few large U.S. funds,” Castree notes. “They have ‘grown up’ using third-party administrators; so, in many respects, the hedge fund administration business is more established in Europe. In the United States, many funds continued to do their own administration until recently; but the cost and the risk of the in-house function are now making third-party administration a more efficient and effective alternative.”

The possibility that new regulation will create new compliance needs also enhances the value a third-party administrator brings to a hedge fund manager. “An independent administrator cannot substitute for a hedge fund manager’s in-house compliance officer, but it can help a hedge fund understand and respond properly to any regulatory demands that emerge,” Castree says.

...And Their Administrators

As new strategies and trading ideas emerge, hedge fund administrators are continuously pressed to independently value more complex investments in the portfolios. “Credit default swaps were exotic just a few years ago. Now they’ve become commonplace, and we have funds investing in weather derivatives,” says Stuart Drake, senior client executive for Hedge Fund Services. In some cases the distinction between private equity funds and hedge funds is blurred, as hedge funds begin to take stakes in emerging companies. “The hedge fund administrator has to maintain the expertise to assign independent and accurate values to an ever-widening range of innovative investment vehicles,” Drake notes. “Because the hedge fund administration business is still maturing few people have the right combination of experience and service attitude, and they do not come cheaply. This service is not likely to become commoditized anytime soon.”

Institutional fund managers and institutional investors have also increased



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Daily Operational Outsourcing

In February, JPMorgan Worldwide Securities Services (WSS) announced that it agreed to acquire the middle and back office operations of Paloma Partners Management Company (Paloma). Paloma is part of a privately-owned investment fund management group, based in Greenwich, Connecticut.

“Paloma’s experienced personnel and innovative technical platform are very attractive to JPMorgan. This acquisition allows us to immediately offer our hedge fund clients a high quality option — built on top of a hedge fund-specific platform — for outsourcing their daily operations,” said Liz Nolan, global head of Alternative Investment Services for JPMorgan WSS. “We aim to lead the industry in servicing clients with complex alternative investment strategies, and the next step in the growth of our integrated Alternative Investment Services unit is the acquisition of Paloma’s middle and back office operations.”

The parties have also agreed to enter into a multi-year contract for JPMorgan to provide daily operational services to Paloma. “JPMorgan’s experience in supporting the hedge fund segment and quality approach to service ensure that Paloma will have the best-in-class operations and infrastructure to support our investment portfolio,” said S. Donald Sussman, founder of Paloma and owner of the company that manages the Paloma funds. “Outsourcing these functions to JPMorgan at this time allows us to bring even greater focus to the investment side of our business.”

demands on hedge fund administrators for more frequent net asset value (NAV) calculations, timelier reporting, a greater variety of risk metrics and more bespoke reports. Hedge fund managers are also now more often requesting service level agreements that resemble what is seen in the traditional mutual fund world, to establish accountability for delays and errors. On the whole, these trends are positive for investors, but they have impelled big shifts in the world of hedge fund services.

A Changing Playing Field

Boutique firms with custom-built systems, smart and experienced people and a high-touch service approach earned early success in hedge fund administration. As banks and larger asset servicers enter the field, they have found a buy-and-grow strategy more practical than building a business from the ground up or retooling mutual fund administration systems to meet very different hedge fund needs. HSBC bought Bank of Bermuda, BISYS acquired Hemisphere, Bank of New York bought IFA, State Street Bank bought IFS, Citigroup acquired Forum and Mellon bought DPM. JPMorgan’s acquisition of Tranaut Fund Administration in 2004 offers another example of this trend.

Founded in Dublin in 1999, Tranaut was established to set higher service standards for single-strategy hedge fund managers with big ideas but small operations and staff. Stuart Drake and his team built a customized system for hedge fund share registry and transfer agency, staffed their team with accountants who all had deep hedge fund specific experience and a customer service focus.

“As we saw hedge funds becoming more institutionalized, we recognized the need to align ourselves with a bigger partner and a bigger balance sheet if we wanted to grow market share,” says Drake. “As part of JPMorgan, we can take advantage of opportunities to serve larger funds and add capabilities to our offerings.”

Clients are the beneficiaries of these combined capabilities. As evidence, Drake describes a client with a portfolio of collateralized debt obligations (CDOs) and bank debt wrapped into a hedge fund and valued at \$1 billion. Between JPMorgan Tranaut and FCS, a service provider for leveraged loan investors, JPMorgan can provide this fund manager with expert service on several highly specialized fronts, all from under one roof.

A big attraction for JPMorgan was Tranaut’s emphasis on quality. “In a world where much of the service delivery was mediocre, Tranaut had built a sterling reputation for low staff turnover, zero-tolerance for NAV errors and never losing a client,” says Malde. “Together we are looking at ways to use JPMorgan’s technology and systems to scale the operation and increase its efficiency without compromising that quality.”

Moving to Daily Operational Outsourcing

JPMorgan’s recent acquisition of middle and back office operational capability of Paloma Partners Management Company complements the existing hedge fund administration services with an ability to provide daily operational services to multi-strategy hedge funds. “The work of managing the day-to-day middle and back office operations for a fund is another area where a third-party provider can bring the independence and credibility that institutional hedge fund investors appreciate,” says Malde. “From the manager’s perspective, outsourcing can turn a high fixed overhead cost into a more manageable variable cost that moves with asset levels. It also frees more resources to allocate to the core business of trading.”

JPMorgan evaluated several options for building its middle and back office outsourcing capability and settled on Paloma for several reasons.



Peter Salvage

First, the platform was created for a large multi-strategy hedge fund. “Our customers have different deadlines, different valuation needs and different trading relationships than traditional mutual fund managers. We needed a hedge fund specific platform to get the service right for our clients” said Peter Salvage, global product head for Hedge Fund Operations, the middle and back office outsourcing product. Another key in the decision was the breadth of capabilities in the Paloma operation. “We have customers using all major trading strategies and we’re seeing more multi-strategy funds. Over the last 16 years the Paloma staff and systems have handled every major strategy from statistical arbitrage to relative value fixed income. The strength of their people and technology really stood out,” Salvage said.

Due Diligence Checklist for Evaluating a Hedge Fund Administrator

The quality of a hedge fund's administrator is vitally important to the risk profile of hedge fund managers and investors. The following are key questions central to performing due diligence on any current or prospective hedge fund service provider:

- ▶ How is the administrator's operation staffed? Do they have experienced, well-trained professionals and a commitment to keeping them? How do they assure the ethical conduct and integrity of their personnel?
- ▶ Where is the administrator located? Are its locations compatible with the fund's jurisdictions?
- ▶ Is the administrator directly regulated?
- ▶ What is the administrator's service philosophy? Who is the primary point of contact? How many clients is each person expected to serve? How are investor inquiries handled?
- ▶ How does the administrator value complex investments? Does it have independent and reliable information sources for instruments such as OTC derivatives and structured products?
- ▶ What kind of controls are in place for managing operational risk? What is the ratio of automation to human judgment in the administrator's processes?
- ▶ What kind of technology does the administrator have in place? How is it used? Are the systems geared toward the investor and the balance sheet or toward the manager and the P&L? Does the technology focus on reducing errors and improving efficiency or is it intended as a substitute for person-to-person contact?
- ▶ What are the administrator's disaster recovery and business continuity plans?
- ▶ What middle office or other ancillary value-added services can or does the administrator provide?
- ▶ What are its reporting capabilities? Are reports accessible when you need them? Can you customize reports and import data to internal systems?
- ▶ How does the cost of the service relate to its value? The fee for hedge fund administration ranges from five to 25 basis points, depending on the complexity of the portfolio and the level of service demanded.

pendent NAV verification as well as the accounting, investor communications, setup assistance, corporate secretarial services, Web reporting and other checks and balances that a third-party hedge fund administrator provides.

Other fund of funds needs require unique responses, however. For example, fund of funds managers have their own subscription and redemption time frames, but they also have to comply with the various subscription and redemption frameworks among the single-manager funds in their portfolios. Differences in timing here can create specific credit and liquidity needs for the fund of funds managers to meet their obligations to their investors. In addition they often need a custodian to hold the documents certifying their investments in the underlying funds. Where a single-strategy fund manager can turn to its prime broker for credit and custody, the fund of funds manager does not use a prime broker, and therefore, has to look elsewhere for these services.

At the end of 2005, JPMorgan introduced a Fund of Hedge Funds Solution that bundles administration, document custody and cash management services for a single asset-based fee. "Our fund of funds solution integrates the capabilities of JPMorgan Tranaut with those of JPMorgan's Treasury Services businesses to meet client needs," says Malde.

"The Fund of Hedge Funds Solution, along with others on the drawing board, epitomizes JPMorgan's response to the dynamic hedge fund market." As Malde sums up, "We are bringing together core JPMorgan strengths with newly acquired specialized skills and investing the resources necessary to distinguish our services and make JPMorgan the market's highest-quality provider." ○○○

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With middle and back office outsourcing and third-party fund administration, JPMorgan can now offer hedge funds a variety of options for increasing efficiency and accuracy in its operations.

Distinctive Needs of Funds of Funds
Multi-manager funds of hedge funds

demonstrate the need for different service bundles. They face some challenges common to single-strategy hedge fund managers, along with others that are distinct to their structure.

Similar to single-strategy hedge funds, funds of funds can also benefit from inde-